No. 13239

In the United States Court of Appeals for the Ninth Circuit

BEN A. PUENTE and MARION PUENTE, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

ELLIS N. SLACK,
Acting Assistant Attorney General.

HELEN GOODNER,
CARLTON FOX,
Special Assistants to the Attorney General.

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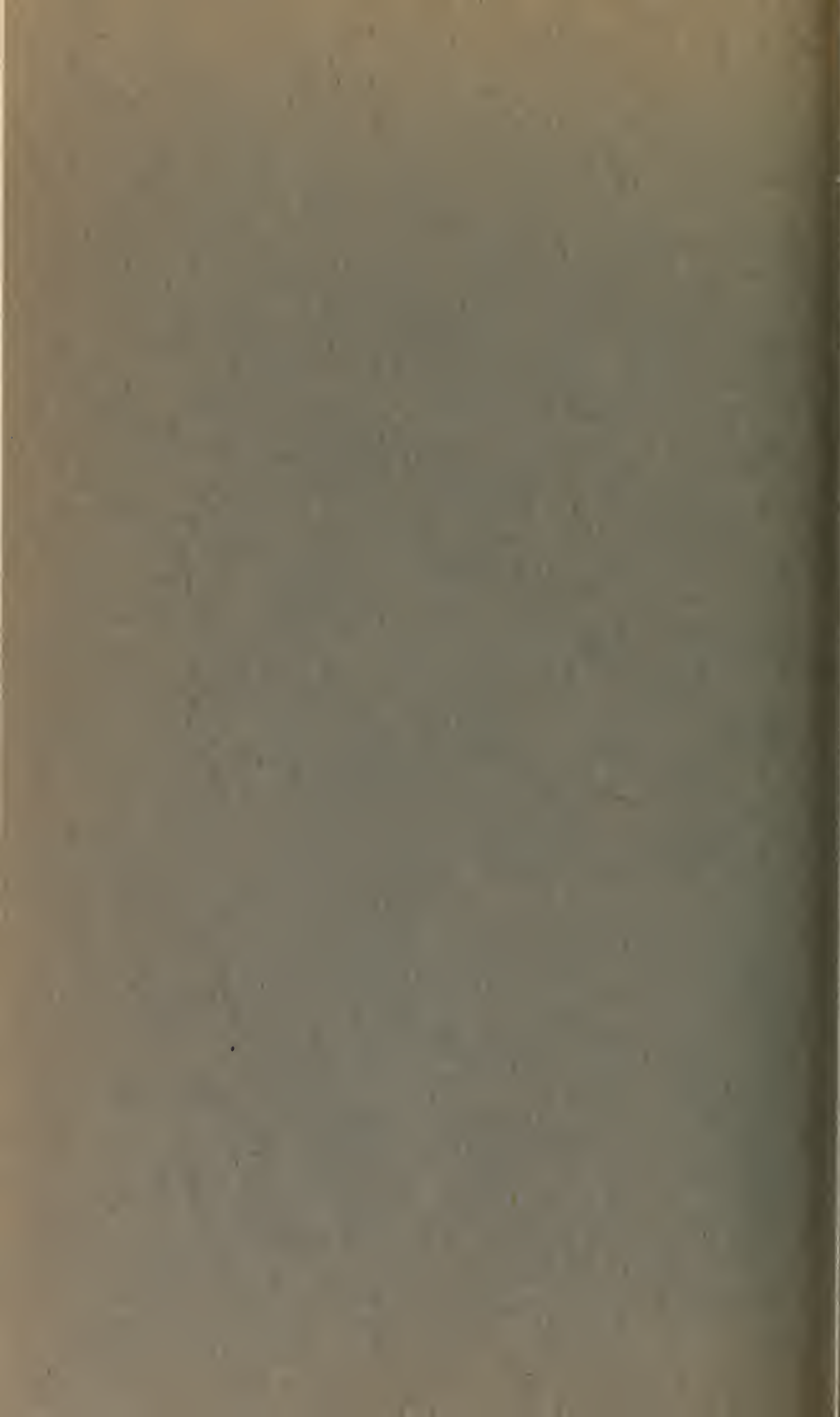

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The Tax Court's memorandum findings of fact and opinion (R. 17-21), entered August 20, 1951, are not reported.

JURISDICTION

The petition for review (R. 26-30) involves a deficiency in income and victory taxes determined by the Commissioner against the taxpayers, Ben A. Puente and Marion Puente, for the taxable year 1943. On June 8, 1949, the Commissioner mailed the taxpayers a notice of deficiency in such taxes for that year. (R. 5,

11-14) Within 90 days thereafter and on September 6, 1949, the taxpayers filed a petition with the Tax Court of the United States for a redetermination of the deficiency for the taxable year 1943 (R. 3), under Section 272(a)(1) of the Internal Revenue Code. The decision of the Tax Court that there is a deficiency in income and victory tax for the year 1943 in the amount of $191.66 was entered September 24, 1951 (R. 22), and the case is brought to this Court by a petition filed December 24, 1951 (R. 4, 26-30), under the provisions of Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the taxpayers sustained a net operating loss in 1945 under Section 122(d)(5) of the Internal Revenue Code, which they could carry back to the taxable year 1943 under Section 122(b) thereof, on account of a loss sustained by them in 1945 on foreclosure sale of their dairy cattle herd and equipment used by them in their dairy farm business in 1944 and 1945.

STATUTES INVOLVED

These are set out in the Appendix, *infra.*

STATEMENT

The facts as found by the Tax Court are based largely upon a stipulation (R. 23-25) and may be summarized as follows:

The taxpayers, Ben A. Puente and Marion Puente, husband and wife, in the years 1944 and 1945 were engaged in the dairy farming business at Lodi, California, on a rented farm. The taxpayers' dairy and

cattle herd, as well as their farm equipment, was bought on credit, their debt for the purchase price having been secured by a chattel mortgage thereon. In 1945 both the herd and the equipment were sold at foreclosure sale at the insistence of the mortgage holder, resulting in a loss of $4,575.30. (R. 19.)

The full amount of the loss was included by the taxpayers in their computation of a net operating loss for 1945. They filed a claim for refund of all income and victory taxes assessed and paid on their income and victory tax return for the calendar year 1943, on the basis that the net operating loss was computed in accordance with Section 122 of the Internal Revenue Code and was allowable as a net operating loss carry-back for the year 1943. The Commissioner denied the claim. (R. 19.) The deficiency determined by him resulted in part from such disallowance. (R. 13.)

SUMMARY OF ARGUMENT

Four Courts of Appeals, in six cases, have decided the question here presented against the taxpayers' contention. The decisions in these cases were considered and are correct. They should, therefore, be followed here. A consideration of the language of Section 122(d) (5) of the Internal Revenue Code discloses an intention on the part of Congress to include in net operating losses for carry-back and carry-over purposes only such losses as were sustained by a taxpayer in the normal and continuous operation of his business, and not those sustained by him in the course of its liquidation. The fact that, under Section 23(e)(1), the taxpayers are allowed an ordinary de-

duction for. gross income in the taxable year 1945 on account of the loss here in question does not establish that such loss is a "net operating loss" under Section 122(d)(5), which may be spread over a five-year period, as provided in Section 122(b). The taxpayers' assertion to the contrary not withstanding, the history of the "net loss" provisions of prior Revenue Acts, and the decisions under them, support this view. The provisions of Article 651 of Treasury Regulations 74, promulgated under the net loss provisions of the Revenue Act of 1928, upon which the "net operating loss" provisions of the Code are said to be based, to the effect that "net losses" include losses from the sale of capital assets used in a trade or business, do not support the taxpayers' contention that a loss sustained by them on the sale of their dairy cattle herd and dairy equipment upon the termination and liquidation in 1945 of the dairy business they had theretofore conducted constitutes a net operating loss, which they could carry back to the taxable year 1943, within the meaning of Section 122(d)(5). This Regulation was promulgated to carry into effect the provisions of Section 117(a)(2) of the 1928 Act, relating to the computation of capital net losses, the counterpart of which is Section 122(d)(4) of the Code, not here involved. The taxpayers' assertion that liquidating losses sustained by corporations are treated as net operation losses under that section is incorrect, and their conclusion that similar losses sustained by individuals should likewise be so considered is irrelevant. The construction placed by applicable Treasury Regulations upon Section 23(k)(1) of the Code relating to

business losses, so as to differentiate between the treatment taxwise of business and non-business losses, is also irrelevant here.

ARGUMENT

The Taxpayers did not Sustain a Net Operating Loss in 1945, under Section 122(d)(5) of the Internal Revenue Code, which they could carry back to the Taxable Year 1943, under Section 122(b), on Account of a Loss Sustained by them in 1945 on a Foreclosure Sale of their Dairy Herd and Equipment used by them in the operation of their Dairy Business in 1944 and 1945.

A. Four Courts of Appeals Have to Date Held That Losses Sustained on the Sale of Business Assets Upon the Termination of a Business are not Attributable to Its Operation Within the Meaning of Section 112(d)(5)

Before proceeding with a consideration of the proper construction of the net operating loss provisions of Section 122(d)(5) of the Internal Revenue Code (Appendix, *infra*), upon which the taxpayers rely for their claim that they are entitled to a net operating loss carry-back for the year 1945 to the taxable year 1943, on account of a loss which they sustained in 1945 as a result of the liquidation of their dairy business and the foreclosure sale of their dairy herd and equipment, it should be pointed out that four Courts of Appeals, namely, the Eighth, Second, Fifth and Sixth, in the order named, have rejected the same contention as is made by the taxpayers here, the Eighth and Second Circuits having twice rejected it to date. The Eighth Circuit's decisions were rendered in the cases of *Lazier* v. *United States,* 170 F. 2d 521, and *Sic* v. *Commissioner,* 177 F. 2d 469, certiorari denied, 339 U. S. 913; the Second Circuit's in the cases of *Merrill* v. *Commissioner,* 173 F. 2d 310, and *Baruch* v.

Commissioner, 178 F. 2d 402; the Fifth Circuit's in the case of *Pettit* v. *Commissioner,* 175 F. 2d 195; and the Sixth Circuit's in the case of *Smith* v. *United States,* 180 F. 2d 357. To be sure, the taxpayers assert that all of these cases were erroneously decided because, as they say, all of them rest upon an alleged erroneous decision of the Tax Court in the case of *Sic* v. *Commissioner,* 10 T. C. 1096 (affirmed, as stated, by the Eighth Circuit, as well as upon an alleged equally erroneous ruling of the Income Tax Unit of the Bureau, namely, I. T. 3711, 1945 Cum. Bull. 162.

In any case, the taxpayers' contention (Br. 6), that these decisions are based on a " 'follow-the-leader' down the path of least resistance pattern," is entirely unfounded. In this connection, it is to be noted that both decisions of the Eighth Circuit, namely, those rendered in *Lazier* v. *United States* and *Sic* v. *Commissioner, supra,* as also the decision of the Second Circuit in *Merrill* v. *Commissioner, supra,* obviously gave full and independent consideration to the problem. Indeed, the Eighth Circuit in the *Sic* case appears to have reconsidered its former opinion in the *Lazier* case in the light of the claim of the taxpayer there that its former decision in the case of *Washburn* v. *Commissioner,* 51 F. 2d 949 (hereinafter again referred to), decided under the net loss provisions of Section 204(a) and (b) of the Revenue Act of 1921, c. 136, 42 Stat. 227, was inconsistent with its holding in the *Lazier* case, concluding that it was not. Moreover, so far as concerns the decision of the Second Circuit in the *Merrill* case, it seems that, while in the *Lazier* case the Eighth Circuit considered the decision of the Tax

Court in the *Merrill* case (*Merrill* v. *Commissioner,* 9 T. C. 291), the Court of Appeals for the Second Circuit does not appear to have decided the problem on the basis of any authority, but solely upon its own evaluation of the applicable principles.

To be sure, the taxpayers say (Br. 6-7) that both the Eighth Circuit in the *Lazier* case and the Fifth Circuit in the *Pettit* case indicated that there may have been some doubt as to the construction of Section 122(d)(5). But such doubt as there was was obviously resolved by both courts in favor of the construction placed thereon by the Commissioner and against that placed thereon by the taxpayers. It was of course the function of these courts to resolve such doubt. See *White* v. *United States,* 305 U. S. 281, 292. As the Supreme Court pointed out in *Webre Steib Co.* v. *Commissioner,* 324 U. S. 164, 169, the difficulties presented in the construction of taxing statutes will not excuse the Court from the duty to apply as best as it may a statute Congress has seen fit to enact.

While this Court is not bound to follow the decision of another Circuit, it is well settled that one Court of Appeals will follow the decision of another unless it believes such decision to be erroneous. See e.g., *Grain Belt Supply Co.* v. *Commissioner,* 109 F. 2d 490, certiorari denied, 310 U. S. 648, where the Eighth Circuit followed a prior decision of the Tenth Circuit, because, as the court said, it would not be justified in refusing to do so unless it was satisfied that the decision was erroneous, which it was not. And, in the case of *United States* v. *Armature Rewinding Co.,* 124 F. 2d 589, 591, the same court followed a prior

decision of this Court for the same reason. The converse of this principle is, of course, also true; that is to say, that a Court of Appeals will not follow the decision of another Court of Appeals if it believes that decision to be erroneous. See e.g., *Reo Motors* v. *Commissioner,* 170 F. 2d 1001, where the Sixth Circuit refused to follow a prior decision of the Fifth Circuit, the conflict which had thus arisen having been settled by the Supreme Court in *Reo Motors* v. *Commissioner,* 338 U. S. 442. It is thus apparent that Courts of Appeals consider it their duty to determine for themselves whether the decisions of other Courts of Appeals are correct before they undertake to follow them. It cannot therefore, in any event, be properly charged that the Courts of Appeals for the Second, Fifth and Sixth Circuits, in the *Baruch, Pettit* and *Smith* cases, *supra,* blindly followed the decision of the Eighth Circuit in the *Lazier* case. We turn to a discussion of the proper construction of Section 122(d)(5) of the Code.

B. A Reference to the Language of Section 122(d)(5) Suffices to Demonstrate the Correctness of the Commissioner's Construction Thereof Which the Four Courts of Appeals Have Approved

Section 23(s) of the Internal Revenue Code (Appendix, *infra*) provides for the allowance of a net operating loss deduction for any taxable year beginning after December 31, 1939, computed under Section 122. Section 122(a) (Appendix, *infra*) defines the term "net operating loss" to mean the excess of deductions allowed by the income tax chapter of the Code over the gross income, "with the exceptions, additions, and limitations provided in subsection (d)." Subsection (d) sets such exceptions, additions, and

limitations out in five paragraphs numbered from (1) to (5) inclusive. It is agreed, however, that the only paragraph here in question is paragraph (5), which reads as follows:

> (5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.

It follows that, if the taxpayers' loss here in question is not attributable to the operation of the business which they carried on in 1944 and 1945, they sustained no net operating loss in 1945 within the meaning of Section 122(d)(5), which they could carry back to the taxable year 1943 under Section 122(b). (Appendix, *infra*).

The Commissioner determined that the loss which the taxpayers sustained in 1945 as a result of the foreclosure sale of their dairy herd and equipment was not a loss which occurred in the operation of their dairy business in that year and was therefore not attributable to such operation within the meaning of Section 122(d)(5), but was a loss resulting from the liquidation of that business after it had been terminated, i.e., after its operation had ended.

The only business which the taxpayers carried on in 1944 and 1945 was the dairy business. They were not engaged in the business of buying and selling dairy cattle and dairy equipment. It follows, therefore, that reference to the language of the statute should suffice to demonstrate the correctness of the Commissioner's interpretation of Section 122(d)(5), which, as stated, four Courts of Appeals have already approved, for the statute is concerned only with net *operating* losses, i.e., here, losses sustained in the *operation* of the taxpayers' dairy business, and not with liquidating losses sustained by them in the course of winding up that business after its operations had been discontinued.

The error in the taxpayers' contrary contention is largely induced by the fact that they have disregarded the emphasis to be placed upon the word "operation" in the phrase "attributable to the operation of a trade or business," used in Section 122(d)(5). See *Hartley* v. *Commissioner,* 72 F. 2d 352, 357 (C. A. 8th), affirmed, 295 U. S. 216, which deals *inter alia* with similar language contained in Section 204 of the Revenue Act of 1924, c. 234, 43 Stat. 253, embodying the "net loss" provisions of that Act. Moreover, as the Eighth Circuit said in the *Lazier* case, *supra,* p. 526, Section 122(d)(5) of the Code may, and therefore must be, considered as referring to losses attributable to the normal operation of the business which the taxpayers carried on, and not to losses attributable to a partial or total liquidation of the physical properties used in the conduct of the business. The taxpayers, however (Br. 14-16), have placed the emphasis upon the word "attributable" in that phrase, and in so doing

have assumed, without more, that the liquidation of their dairy business upon its termination, and the forced sale of their dairy herd and equipment in the course of such liquidation, was still an activity carried on by them in the *operation* of their business, and was for that reason "attributable" thereto, within the meaning of Section 122(d)(5). Thus they have assumed the very point in issue here, namely, whether the loss resulting from the sale of the dairy herd and equipment, which they had used in the operation of the dairy business that was discontinued and liquidated, was "attributable" to such operation, within the meaning of that section.

In this connection, the taxpayers have also assumed (Br. 26-27), erroneously we submit, that, because the loss was allowable as an ordinary deduction in computing net income under Section 23(e)(1), as having been "incurred in trade or business," i.e., incurred in their dairy business, within the meaning of that section, it is likewise allowable as a net operating loss under Section 122(d)(5) as one "attributable to the operation" of that business. The fallacy of this contention lies in the fact that it ignores the fundamental difference in the language and purpose of the two sections. The provisions of Section 23(e)(1) are broad, but the deductions therein provided are confined to the taxable year; that is, this section provides for deductions "incurred in trade or business," in the taxable year. Its provisions must, therefore, be sharply contrasted with the much narrower provisions of Section 122(d)(5), which limit the deductions allowed thereby to losses attributable to the "operation" of a trade or business,

i.e., as stated, to "operating losses," which, by contrast, are to be spread over a five-year period, including the taxable year and the two years immediately preceding and following it.

Indeed, to hold that such "net operating losses" are not confined to those which are sustained in the "operation," i.e., the ordinary, normal, continuing activities of the business, would thwart the Congressional purpose which was to permit the spread over a five-year period only of net operating losses of a taxpayer whose business fluctuated from year to year over such period. Thus, under the statutory scheme of spreading such losses over such period, each succeeding taxable year becomes the center of a new net operating loss deduction cycle, and, in order to insure that only net loss from the operation of taxpayer's business in a given year would thus be spread over the indicated five-year period, Section 122(d)(3) (Appendix, *infra*), provides that, in computing the net operating loss for such year, no net operating loss deduction should be allowed.

In short, as indicated, the losses which Congress here envisioned are those which normally might be expected to occur in a given year in the course of the normal operation of the business during that year. We submit that, in the light of such purpose it seems clear that a liquidating loss incurred in the course of winding up the business is not the kind of a loss which Congress had in mind in describing it as one which was "attributable to the operation of a trade or business regularly carried on by the taxpayer."

C. The History of, and the Decisions Dealing With the "Net Loss" Provisions of Prior Revenue Acts Supports the Commissioner's Construction of Section 122(d)(5)

Contrary to the taxpayer's contention (Br. 10-14), the Commissioner's rejection of their claim for refund is also supported by the history of, and the decisions dealing with, the "net loss" provisions of prior Revenue Acts, in which, as the taxpayers correctly say (Br. 17), the net operating loss provisions of the Code had their origin.

The first net loss provision was enacted as Section 204(a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057. This section provided for carry-back of (1) a net loss incurred in the "operation of any business," or (2) losses on the sale in 1919 of war facilities. Apparently the only decision rendered under the provisions of this section is that of the Court of Claims in the case of *Auburn & Alton Coal Co.* v. *United States,* 61 C. Cls. 438.

This case involved a loss from the sale of all of the taxpayer's capital assets consisting of coal mines, mining rights, equipment and other property, none of which was acquired for the production of articles contributing to the prosecution of the war. It was therefore necessary for the taxpayer to bring itself within the provisions of paragraph (1) of this section, which, as stated, provided that, as used therein, the term "net loss" meant only net losses resulting from "(1) the operation of any business regularly carried on by the taxpayer." The court said that, even assuming a "net loss" could be held to cover the sale of a plant, buildings, machinery or equipment or other facilities, it could only, in view of clause (2), reasonably be held to

include the sale of property acquired for the production of articles for the prosecution of the war, that being sufficient in the court's view to prevent the taxpayer's recovery. However, the court went on to say (p. 444):

> If anything further were needed to sustain this conclusion, it is found in the language of (1) of paragraph (a), which is confined to net losses resulting from the "operation of any business regularly carried on." It would at least be somewhat straining the regularly accepted meaning of this language to say that a loss resulting from the sale of all of its plant, buildings, machinery, equipment, or other facilities, which meant a suspension of business, was a loss sustained in the regular conduct of the business. It was a part in fact of an operation end-business, at least temporarily, and certainly as to this plant, etc. This, however, is strengthened by the provision of (2) of paragraph (a), which alternatively provides for a deduction growing out of the sale of a plant, etc., acquired for the production of articles for the prosecution of the war.

The court then pointed out that the changes made by Section 204 of the Revenue Act of 1921, c. 136, 42 Stat. 227, were not controlling of the construction of the 1918 Act. The point is that by Section 204(a) of the 1921 Act the definition of a net loss resulting from the "operation of any business regularly carried on by the taxpayer" was expanded so as expressly to include "losses sustained from the sale or other disposition of

real estate, machinery, and other capital assets, used in the conduct of such trade or business."

Several cases were decided arising under this Act, the most important of these being the case of *Washburn* v. *Commissioner,* already referred to. In that case the Eighth Circuit held that the taxpayer was engaged in the business of organizing and managing corporations, and that a loss sustained by him on the sale of the stock of one of them was a net loss within the provisions of Section 204(a), which, as stated, required the inclusion, for net loss purposes, in losses sustained in the operation of any trade or business regularly carried on by the taxpayer of "losses sustained from the sale or other disposition of real estate, machinery, and other capital assets."

It should be stated here that in *Sic* v. *Commissioner, supra* (pp. 805-806), the Eighth Circuit itself pointed out that the *Washburn* case had no application in the construction of Section 122(d)(5) of the Code, because of the difference in the provisions of Section 204(a) of the 1921 Act and those of Section 122(d)(5). Consequently the court said that its decision in the *Washburn* case did not justify overruling its decision in *Lazier* v. *United States, supra.* For further comment on the *Washburn* case, see this Court's decision in *McGinn* v. *Commissioner,* 76 F. 2d 680, 681; the Second Circuit's decision in *Dalton* v. *Bowers,* 56 F. 2d 16, 18, affirmed, 287 U. S. 404, which involved the provisions of Section 206(a) of the Revenue Act of 1924, c. 234, 43 Stat. 253, presently explained, and *Higgins* v. *Commissioner,* 312 U. S. 212, 216-217.

Another case which arose under Section 204(a) of the 1921 Act that should be mentioned here is the Second Circuit's decision in *Schuette* v. *Anderson,* 55 F. 2d 902. The court in that case, however, denied net loss status to the loss sustained by the taxpayer because, in the court's view, the taxpayer was not regularly carrying on a business, so that the loss was not an incident of a business, but rather whatever activities she was carrying on were incident to the loss, and that the law did not contemplate this. In this behalf the court said (p. 903):

> It [the law] spoke of a business operated on its own account, not of efforts ancillary to the final disposal of a bad investment. * * *

And this brings us to the third and last case decided under the 1921 Act, which needs discussion, namely, *Burnet* v. *Marston,* 57 F. 2d 611 (C.A. D.C.), the only one decided thereunder that is cited by the taxpayers (Br. 11-12), but was distinguished by the Second Circuit in *Merrill* v. *Commissioner, supra,* and does not in the least support their contention.

Indeed, this case did not even involve the sale of capital assets. The losses there in question were sustained by a partnership in the operation of its business in the year 1920, in which it was dissolved and in which the partners liquidated its liabilities totaling about $3,750,000. The taxpayer's share of these losses was $725,473.99, and there was no question that they had resulted from the operation of the partnership's business in 1920. The taxpayer, however, did not pay his share of such losses until 1922. It was also con-

ceded that the taxpayer was entitled to deduct such losses from his gross income in 1922. This left him with a net business loss of $92,102.52 in that year, and the sole question was whether he could carry that loss over to 1923. The Commissioner had held that he could not, but the Court of Appeals held that he could. The court said that the mere fact that the taxpayer had paid his share of the loss in 1922 instead of 1920 did not deprive him of the benefit of Section 204.

Turning, then, to Section 206(a) of the Revenue Act of 1924, c. 234, 43 Stat. 253, we find that inclusion of "losses sustained from the sale or other disposition of real estate, machinery and other capital assets" in the "operation of any trade or business regularly carried on by the taxpayer," was deleted. That section, instead, provided that the term "net loss" meant the excess of deductions allowed by Sections 214 (Applicable to individuals) and 234 (applicable to corporations) over gross income, with the following exceptions and limitations:

> (1) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall be allowed only to the extent of the amount of the gross income not derived from such trade or business;
>
> (2) In the case of a taxpayer other than a corporation, deductions for capital losses otherwise allowed by law shall be allowed only to the extent of the capital gains;
>
> * * *

The provisions of Section 206(a) of the 1924 Act have been reenacted in substantially the same form in Section 206(a) of the Revenue Act of 1926, c. 27, 44 Stat. 9, and Sections 117(a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169. However, as the taxpayers point out (Br. 11), the provisions of Section 117 of the Revenue Act of 1932 were in effect only a short time, for they were repealed by Section 218 of the National Industrial Recovery Act, c. 90, 48 Stat. 195, and were thereafter replaced by the net operating loss provisions, which were added to the Code as Section 122 by Section 211 of the Revenue Act of 1939, c. 247, 53 Stat. 862.

The leading case under the 1924 Act, and hence controlling, so far as applicable, of the construction of the net loss provisions of all subsequent Revenue Acts, is, of course, *Dalton* v. *Bowers,* 287 U. S. 404, already referred to. That case, however, dealt primarily with the question whether a stockholder's activities in connection with the business of a corporation constituted a business conducted by him.

The Court held that it did not, and for this reason affirmed the Second Circuit's decision denying the taxpayer the benefit of Section 206(a). The taxpayer had sustained a loss in the amount paid by him for stock in a corporation which was liquidated and which the taxpayer had originally established to manufacture and market articles invented by him. The Supreme Court said it approved the statement of the court below to the effect that, by the statute allowing the deduction and carrying over the loss for two years, Congress intended to give relief to persons

engaged in an established business for losses incurred during a year of depression in order to equalize taxation in the two succeeding and more profitable years; that it was not intended to apply to occasional or isolated losses. And that, of course, applies with the same force here, for the liquidating loss here in question was no less an occasional or isolated one than the loss in the *Dalton* case. It was a loss the like of which could never have occurred again in connection with the taxpayers' business, since it occurred in the course of the liquidation of that business.

Of course, *Dalton* v. *Bowers,* has consistently been followed since. See, e.g., *McGinn* v. *Commissioner, supra; Gruver* v. *Helvering,* 70 F. 2d 292 (C.A. D.C.); *Holmes* v. *Commissioner,* 99 F. 2d 822 (C. A. 2d); *Stephenson* v. *Commissioner,* 101 F. 2d 33 (C. A. 6th), certiorari denied, 307 U. S. 467; *United States* v. *Wooten,* 132 F. 2d 400 (C. A. 5th).

D. The Provisions of the Treasury Regulations Promulgated Under the 1928 Act do not Support the Taxpayers' Contentions

But the taxpayers say (Br. 16) that, under Article 651 of Treasury Regulations 74, promulgated under Section 117(a) of the 1928 Act, "net losses" include losses from the sale or other disposition of real estate, machinery and other capital assets used in the conduct of such trade or business. The contention is that the same rule should have been applied here by the Commissioner, since the net operating loss provisions of the Code derive from the net operating loss provisions of the 1928 Act.

What the taxpayers have failed to state is that, immediately following the statement in Article 651 of the Regulations above referred to, the reader is directed to see Section 101 of the 1928 Act relating to net capital losses, and to Article 503 of the same Regulations promulgated with reference to the computation of such losses. The occasion for this reference, however, is the fact that Section 117(a)(2) of the 1928 Act provides that, in computing the net loss of the taxpayer under that section, deductions for capital losses otherwise allowed by law shall be allowed only to the extent of capital gains. It is to be noted that a similar provision is contained in Section 122(d)(4) of the Code. But, as we said at the outset of our argument, the only paragraph of Section 122(d) which is here in question is paragraph (5). Thus, since paragraph (4) is not inolved here, it is obvious that the Regulations promulgated to carry its 1928 prototype into effect can have no possible application.

E. The Taxpayer's Contention is Pointless That by Applicable Tax Court Decisions Corporate Losses are Accorded Different Treatment From Individual Losses Under Section 122(d)

The taxpayers further contend (Br. 24-26) that since, as they assert, a corporation is entitled to a net operating loss under Section 122(d)(5) on account of a liquidating loss, no reason is perceived why an individual should not be entitled thereto. In support, the taxpayers cite *Northway Securities Co.* v. *Commissioner,* 23 B.T.A. 532, and *Acampo Winery & Distilleries, Inc.* v. *Commissioner,* 7 T. C. 629. But neither of these decisions supports the taxpayers' contention.

The *Northway Securities Co.* case was decided under

Section 204(a) of the 1921 Act, which, as stated, specifically provided that a net loss resulting from the operation of a business should include losses sustained from the sale of capital assets used in its operation.

As regards the case of *Acampo Winery & Distilleries, Inc.,* it appears from the Tax Court's opinion (p. 640) that the parties had stipulated facts from which a net operating loss deduction in 1943, on account of a net operating loss sustained by the taxpayer in 1944 and 1945 could be computed. As pointed out by the Tax Court, the Commissioner's sole contention was that no deduction could be allowed because the taxpayer was "substantially liquidated and marking time" during 1944 and 1945, and "was no more the *taxpayer* it was in previous years, in substance and in fact, than if it had legally changed its existence." The Tax Court rejected this contention. It does not appear from the Tax Court's report what the nature of the loss was which the taxpayer had sustained in 1944 and 1945, and there is nothing whatever to show that it was a liquidating, as distinguished from an operating, loss.

F. The Construction Placed by Applicable Treasury Regulations Upon Section 23(k)(1) of the Code is Irrevelant Here

Finally, the taxpayer contends that the position which the Commissioner has taken here is inconsistent with the construction he has placed on Section 23(k)(1) relating to business losses in Example (6) of Section 29.23(k)-6 of Treasury Regulations 111, promulgated under the Internal Revenue Code, which provides that a loss in liquidating a trade or business is to be regarded as a proximate incident to its conduct, so as to remove it from the provisions of Section

23(k)(4), which require a worthless non-business debt to be treated the same as a loss of a capital asset. If we assume, as we must for the purposes in hand, that this regulation is valid, it is obvious that Congress did not intend to have the capital gain treatment of non-business losses under Section 23(k)(4) apply to losses incurred in liquidating a trade or business under Section 23(k)(1). But it does not follow that because thereof Congress intended to allow a net operating loss for carry-back and carry-over purposes on account of a liquidating loss, under Section 122(d)(5).

It follows that the Tax Court's decision, denying the taxpayers a deduction in the taxable year of a net operating loss carry-back of the liquidating loss it sustained in 1945, is correct.

CONCLUSION

For the reasons stated, the decision of the Tax Court should be sustained.

Respectfully submitted,

Ellis N. Slack,
Acting Assistant
Attorney General.

Helen Goodner,
Carlton Fox,
Special Assistants to
the Attorney General.

May, 1952.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(s) [as added by-Sec. 211, Revenue Act of 1939, c. 247, 53 Stat. 862]. *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 122 [as added by Sec. 211, Revenue Act of 1939, *supra,* and amended by Secs. 105 and 153 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first

preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941, shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6)

and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

(c) *Amount of Net Operating Loss Deduction.*—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carrybacks to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d)(1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credit provided in section 26 (e)).

(d) *Exceptions, Additions, and Limitations.*—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed

by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) [as amended by Sec. 150(e), Revenue Act of 1942, c. 619, 56 Stat. 798]. Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117(b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains.

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

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